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2010 Review of Tax Cases ©

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Child Tax Credit and Exemptions for Children

Himes v. Com'r, T.C. Memo 2010-97 (5-4-2010)

Issue: Is the taxpayer entitled to the dependency exemption deduction and child tax credits under Sections 151 and 24, respectively, for his two sons from a prior marriage?

Facts: Leslie Himes was married to Barbara Wyke and they had two children together referred to as MH and GH. In 1995, they divorced. The taxpayer was awarded liberal visitation rights and ordered to make child support payments. That court granted the taxpayer the right to claim a dependency deduction for GH for 1995 and all subsequent years. The District Court judge and taxpayer's attorney signed and executed the divorce decree.

On January 22, 1999, the District Court modified the divorce decree and it provided that the taxpayer was entitled to claim the dependency exemption deduction for both children if he were current on his child support payments at the end of that year. The decree provided the following process for transferring the exemption. First, Ms. Wyke would deliver a release to the exemption to the county clerk. Second, the clerk, upon verification that all child support payments were made, would deliver the release to petitioner. The modified decree was signed only by the District Court judge.

In 1999, without permission of the Court, Ms. Wyke left the state with her two children. She did not provide a forwarding address so the taxpayer lost contact with his children. Despite this taxpayer continued to make his regular child support payments and he claimed the two children as his dependents. Ms. Wyke never signed IRS Form 8332 Release of Claim to Exemption for Child of Divorced or Separated Parents, even though the modified decree specifically required her to do so.

Holding: the taxpayer is **not** entitled to the dependency exemptions because Section 152(e)(2) requires the custodial parent to sign a written declaration either on IRS Form

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8332 or a statement conforming to the substance of Form 8332. The ex-wife (custodial parent) failed to do so, so the non-custodial parent was not entitled to the exemptions. The signature of the custodial parent is a statutory requirement that cannot be waived.

Under Section 24, a taxpayer may establish the qualifying child requirement if the taxpayer establishes entitlement to the dependency exemption deduction under the exception of 152(e)(2). The taxpayer failed to meet that requirement so he was not entitled to the child tax credit either.

Damages

Campbell v. Com'r, 134 T.C. No. 3 (1-21-10)

Facts: In May and December 1995, taxpayer filed two lawsuits against Lockheed Martin ("LM") under the False Claims Act alleging that LM defrauded the U.S. In 2003, the U.S., LM and the taxpayer settled the suits. LM agreed to pay the U.S. $37.9 million. As part of the settlement, the taxpayer received a qui tam payment of $8.75 million for his role as the "relator." The U.S. wired $8.75 million to the taxpayer's attorneys who subtracted their 40% contingency fee or $3.5 million and remitted the difference of $5.25 million to the taxpayer.

The taxpayer included "Other income" of $5.25 million but then omitted the $5.25 million from his taxable income contending no portion was taxable to him because it was a nontaxable share of the U.S. government's recovery. He did disclose the $3.5 million attorney's fee payment on IRS Form 8275, Disclosure Statement in which he argued the $3.5 million attorney's fee payment had been held not to be taxable income by the 11th Circuit. Taxpayer failed to cite any authority for omitting the $5.25 million but he was aware of Roco v. Com'r, 121 T.C. 60 (2003) which holds that qui tam payments are includible in the gross income of the recipient.

Issues:

1. Whether the qui tam payment is taxable income to the taxpayer?

2. Whether taxpayer substantiated that he paid contingent attorney fees from the settlement?

3. If yes, whether the attorney's fee payment is includible in petitioner's gross income and deductible by him as a miscellaneous deduction?

4. Whether taxpayer is liable for a section 6662(a) accuracy-related penalty?

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Short Answers:

1. The entire $8.75 million is taxable income to the taxpayer because it is the equivalent of a reward. Section 61(a) provides gross income is all income from whatever source derived. Courts have given a broad construction to the definition of gross income. Com'r v. Glenshaw Glass Co., 348 U.S. 426, 430 (1955). Exclusions from gross income are narrowly construed. Com'r v. Schleier, 515 U.S. 323, 328 (1995).

2. The taxpayer substantiated the payment of the $3.5 attorney's fee by his own testimony and the written fee agreement.

3. Since the $3.5 attorney's fee was includible in the taxpayer's gross income it can be deducted as a miscellaneous deduction.

4. The opinion included a good discussion of the 6662 penalty and defenses to it. The taxpayer did not have a reasonable basis for his position with regard to the exclusion of the $5.25 million net proceeds so he is liable for the accuracy-related penalty with respect to the net proceeds. Taxpayer's underpayment for purposes of the 6662(b) penalty must be reduced by the portion of the penalty attributable to the $3.5 million attorney's fee payment which was disclosed.

Gift Tax – Transfers of an Interest in a Single-Member LLC

Pierre v. Com'r, 133 T.C. No. 2 (8-24-09).which is supplemented by Pierre v. Com'r, T.C. Memo 2010-106 (5-13-10)

Pierre v. Com'r, 133 T.C. No. 2 (8-24-09) 10-3 vote

Issue: Whether certain transfers of interests in a single-member LLC that is treated as a disregarded entity, pursuant to the check-the-box regulations, are valued as transfers of proportionate shares of the underlying assets owned or the LLC **or** are instead valued as transfers of interests in the LLC and, therefore, subject to valuation discounts for lack of marketability and control? The court noted other issues would be addressed in a separate opinion, which is the May, 2010 opinion. **The issue in this case was a legal issue of first impression.**

Stated differently, the issue is: do the check-the-box regulations require the LLC be disregarded for Federal gift tax valuation purposes?

Facts: Suzanne Pierre received a $10 million cash gift from a wealthy friend in 2000. She wanted to provide for her son and granddaughter but wanted to preserve the wealth. On July 13, 2000, the taxpayer validly formed a single-member LLC in New York and did not elect to treat it as a corporation for Federal tax purposes.

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On July 24, 2000, taxpayer created two trusts, one for her son and one for her granddaughter. On September 15, 2000, taxpayer transferred $4.25 million in cash and marketable securities to the LLC.

On September 27, 2000, the taxpayer transferred her entire interest in the LLC to the two trusts in two steps. First, she first gave a 9.5% membership interest in the LLC to each trust to use a portion of her then available credit amount and her GST exemption.

Second, she then sold to each of the trusts a 40.5% LLC interest in exchange for a secured promissory note. The notes each had a face amount of $1,092,133.

Taxpayer used an appraisal that valued a 1% non-managing interest in the LLC at $26,965. The appraiser determined the value of a 1% interest by applying a 30% discount to the LLC's underlying assets. Taxpayer admitted that because of an error in valuing the underlying assets, a discount of 36.55% was used in valuing the LLC interest for gift tax purposes.

The taxpayer filed a gift tax return reporting the gift of the 9.5% membership interest in the LLC and valued it at $256,168 (9.5 x $26,965). The IRS audited the return and determined that the gift was a gift of the LLC's assets valued at $403,750. The IRS asserted that the taxpayer also made gifts to the trusts to the extent that 40.5% of the LLC's assets exceeded the value of the promissory note. The IRS valued each of the transfers to the trust at $629,117.

Holding: a validly formed single-member LLC is **not** disregarded for Federal gift tax valuation purposes. Accordingly, the taxpayer's transfers to the trusts should be valued for Federal gift tax purposes as transfers of interests in the LLC and not as transfers of a proportionate share of the underlying assets of the LLC.

Analysis: the Court noted that pursuant to New York law the taxpayer did not have a property interest in the underlying assets of the LLC, which is recognized as an entity separate and apart from its members.

The Court noted that the check-the-box regulations govern how a single-member LLC will be taxed for Federal tax purposes, it did not agree that such regulations apply to disregard the LLC in determining how a donor must be taxed under the Federal gift tax provisions on a transfer of an ownership interest in the LLC. If the IRS were right then state law would not apply to define the property rights.

The Court noted that Congress enacted Code Sections 2701 and 2703 that disregard valid State law restrictions in valuing transfers". By contrast, Congress has not acted to eliminate entity-related discounts in the case of LLCs or other entities generally or in the case of a single-member LLC specifically. In the absence of such explicit congressional action and in the light of the prohibition in section 7701, the Commissioner cannot by regulation overrule the historical Federal gift tax valuation regime contained in the

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Internal Revenue Code and substantial and well-established precedent in the Supreme Court, the Courts of Appeal, and this Court…"

Gift Tax – Step Transaction Doctrine

Pierre v. Com'r, T.C. Memo 2010-106 (5-13-10)

Issues:

1. Whether the step transaction doctrine applies to collapse the taxpayer's gift and sale transfers into transfers of two 50% interests in the LLC? Tax Court held it does apply.

2. Whether the lack of control and marketability discounts taxpayer reported should be reduced? The Tax Court found a slight reduction in the lack of control discount and no reduction in the lack of marketability discount.

Facts: The taxpayer was 85 years old when she received the $10 million gift increasing her net worth from about $2 million to $12 million. The taxpayer wanted to provide for her son and granddaughter without eroding her wealth by estate and gift taxes. She turned to her financial advisor and attorneys for advice.

The taxpayer kept $8 million in fixed income securities to generate tax-free income. The taxpayer transferred $4.25 million to the LLC and was the sole member. She had two trusts created, one for her son and one for her granddaughter. She gave each trust a 9.5% LLC interest. The taxpayer did not report the gift to her granddaughter's trust as a direct skip for GST tax purposes. The taxpayer determined the percentages to give based upon the appraiser's report. The appraiser used a 10% lack of control discount and a 30% marketability discount for a 36.55% cumulative discount.

She also sold to each trust a 40.5% LLC interest in exchange for a $1,092,133 note. The notes bore interest at 6.09%, payable in ten annual installments and were secured by the 40.5% LLC interest.

The LLC made distributions to the trust so the trusts could make the yearly interest payments to the taxpayer. No principal payments were made in the eight years since the notes were executed.

The taxpayer was the sole manager of the LLC until she appointed her attorney as her successor. Neither the son nor granddaughter participated in the LLC's management. The attorney conducts the operation of the LLC and held meetings and maintained minutes of its meetings.

The attorney prepared the LLC's general journal and ledger for 2000, the only documents reflecting the capital accounts of the LLC's members. The attorney recorded the taxpayer's initial capital contribution as $3,533,032, the cost basis of the

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$4.235 million of marketable securities she transferred to the LLC. He then credited each trust's capital account with $1,766,516, half the value of the taxpayer's initial capital contribution. He wrote that these adjustments were "to reflect gift transfer by Suzanne Pierre to J. Despretz Trust and K. Despretz Trust" rather than distinguishing the gift transactions from the sale transactions. The attorney used these documents to prepare the LLC's 2000 tax return. However, some time later, the attorney discarded the journal and ledger.

Law: The Court noted that the step transaction doctrine embodies substance over form principles. It treats a series of formally separate steps as a single transaction if the steps are in substance integrated, interdependent, and focused towards a particular result. Citing Com'r v. Clark, 489 U.S. 726, 738 (1989). It is appropriate to use the step transaction doctrine where the only reason that a single transaction was done as two or more seprate transaction was to avoid gift tax. Estate of Cidulka v. Com'r, T.C. Memo 1996-149; Shepherd v. Com'r, 115 T.C. 376, 389 (2000); aff'd 283 F,3d 1258 (11th Cir. 2002); Senda v. Com'r, T.C. Memo 2004-160; aff'd 433 F.3d 1044 (8th Cir. 2006). Whether several transactions should be considered integrated steps of a single transaction is a question of fact.

Analysis: The Court noted that the transfers in question all occurred on the same day and virtually no time elapsed between the transfers. The taxpayer gave away her entire interest in the LLC within the time it took for four documents to be signed. The record indicates taxpayer intended to transfer her entire interest in the LLC without paying any gift taxes.

The court found compelling that the attorney recorded the transfers as two gifts of 50% interests in the LLC in the contemporaneous journal and ledger and that he used these records to prepare the LLC's tax return. The attorney testified at trial that he later discarded these records because they contained inaccuracies, including the characterization of the transfers. The Court noted "We do not so easily ignore Mr. Reiner's contemporaneous description of the transaction."

The Court found that the taxpayer had primarily tax-motivated reasons for structuring the gift transfers as she did. She sold interests in the LLC that were significantly discounted using a 36.55% valuation discount. It noted that no principal payments had been made for eight years. The Court found that nothing of tax-independent significance occurred in the moments between the gift transactions and the sale transactions. It also found that the gift transactions and the sale transactions were planned as a single transaction and that the multiple steps were used solely for tax purposes.

Holding: Accordingly, the Court held the taxpayer made a gift to each trust of a 50% interest in the LLC.

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Regarding the valuation discounts, at trial the taxpayer's expert testified he computed the discounts assuming a gift of a 9.5% LLC interest. He conceded that if a 50% interest was gifted the member would then be able to block the appointment of a new manager but a minority interest would not. He admitted that lack of control discount would be reduced from 10% to 8% so the Court agreed with him.

The taxpayer used a 30% marketability discount and the IRS failed to argue that was too high so the Tax Court accepted it,

Innocent Spouse

Bozick v. Com'r, T.C. Memo 2010-61 (3-30-2010)

This case provides a good discussion of what is required to qualify for "innocent spouse" relief. The wife got relief for 2003.

Jones v. Com'r, T.C. Memo 2010-112 (5-20-2010)

Mortgage Interest

Adams v. Com'r, T.C. Memo 2010-72 (4-13-10)

Taxpayer represented himself and won!

The Court started by noting the issues the parties did not brief, so it focused on the issue the parties did address.

Issue: whether the taxpayer was entitled to the mortgage interest deduction for interest paid on property owned by a trust of which the taxpayer was a beneficiary.

Facts: In 2003, Michael and Zina Gedz transferred legal and equitable title to 325 Essex Drive for a five year period to Equity Holding Corp., as trustee for the Essex Drive Trust pursuant to a trust agreement. A warranty deed memorializing the transfer was recorded. In 2003, the Gedzes assigned a 40% beneficial interest in the Essex Drive Trust to BOGAT Management and a 50% beneficial interest in the Essex Drive Trust to petitioner and his wife. The Gedzes, BOGAT Management and petitioner and wife entered into a beneficiary agreement.

Law: The Court noted the rules covered in Code Section 163(h). Generally, for interest on a mortgage to be deductible the indebtedness must be obligation of the taxpayer and not an obligation of another. Smith v. Com'r, 84 T.C. 889, 897 (1985); aff'd without published opinion 805 F.2d 1073 (D.C. Cir. 1986).

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Reg. 1.163-1(b) provides: "Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness." When a taxpayer has not established legal, equitable, or beneficial ownership of property, we have disallowed the taxpayer's claimed mortgage interest deduction. Hynes v. Com'r, 74 T.C. 1266, 1288 (1980); Song v. Com'r, T.C. Memo 1995-446; Bonkowski v. Com'r, T.C. Memo 1970-340; aff'd 458 F.2d 709 (7th Cir. 1972).

The Court considers certain factors to determine whether a taxpayer is an equitable or beneficial owner of the property, including whether the taxpayer: (1) Has a right to possess the property and to enjoy the use, rents, or profits thereof; (2) has a duty to maintain the property; (3) is responsible for insuring the property; (4) bears the property's risk of loss; (5) is obligated to pay the property's taxes, assessments, or charges; (6) has the right to improve the property without the owner's consent; and (7) has the right to obtain legal title at any time by paying the balance of the purchase price. Blanche v. Com'r, T.C. Memo 2001-63; aff'd 33 Fed. Appx. 704 (5th Cir. 2002).

Analysis: the Court considered Michigan state law and the taxpayer's rights under it and the documents. The Court noted several factors that were in the taxpayer's favor and three factors that suggest that he did not assume the benefits and burdens of ownership including the fact that he could choose to not exercise his right of first refusal and to walk away from the property – which the taxpayer did.

Ruling: the Court concluded "On the unique facts of this case, we conclude that the benefits and burdens that favor ownership outweigh the factors against ownership." So the taxpayer was entitled to the mortgage interest deduction.

Ownership Interest in a Corporation?

Estate of Robert C. Fortunato v. Com'r, T.C. Memo 2010-105 (5-12-2010)

Intro: The IRS determined there was a deficiency in Federal estate tax of $11,662,737 and a Section 6663 fraud penalty of $8,649,140 against the estate.

Issues:

1. Did the decedent own an interest in one or more of a group of warehouse companies on the date of his death?

2. If yes, whether the failure to report the value of the interest(s) on the estate's tax return was fraudulent?

Facts: The trial lasted nearly three weeks and 25 witnesses testified. The record is voluminous – 3,560 pages of testimony and more than 400 exhibits. Some of the

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events on which the trial turned occurred 25 years ago. The estate had four attorneys on the record and the IRS had three.

The Court's opinion is 36 pages and 20 were spent summarizing the facts.

The IRS acknowledged that no stock certificates were issued to the decedent. However, the IRS asserted he was "the boss," he played a key role in forming the companies, on occasion he held himself out as an owner to customers or vendors, and used the companies' bank accounts as his "piggy bank" so decedent owned a beneficial interest in the companies.

Legal Analysis: Courts have held that an individual may be deemed to own stock in a corporation where he/she has a beneficial ownership in the corporation even if no stock certificate was issued. Pahl v. Com'r, 150 F.3d 1124 (9th Cir. 1998); affg. T.C. Memo 1996-176. The Court noted that NJ, Calif. and GA courts all have held that stock certificates are merely evidence, not determinative, of shareholder status and that a legal owner of a corporation may be an uncertificated shareholder. Fulgam v. Macon & Brunswick R.R. Co., 44 Ga. 597, 598 (1872).

The IRS cited several cases to support its arguments. However, the Court held that each of such cases was distinguishable from this case because in the cases the IRS cited there was objective evidence, as demonstrated by the parties' overt acts, but there is not in this case, to show that (1) the putative shareholder intended to acquire an ownership interest in the corporation, and (2) the corporation intended the putative shareholder to become an owner. Shades Ridge Holding Co. v. U.S., 888 F.2d 725 (11th Cir. 1989); Harrell v. Harrell, 290 S.E.2d 906 (Ga. 1982).

The Tax Court found that the decedent never desired or intended to be a shareholder because (1) he was fearful that if his creditors were aware of any assets owned by him, they would attempt (forcibly or otherwise) to collect the debt, and (2) he was worried that his past criminal convictions would stigmatize any company in which he had an ownership interest. He had no financial reason to be a shareholder. He was paid very well but he had no spouse and was estranged from his children.

Holding: the decedent did **not** own an interest in the warehouse companies at his death so the taxpayer won.

Personal Liability for Payroll Taxes

Barry v. Com'r, T.C. Memo 2010-57 (3-24-10)

Facts: Taxpayer operated Barry Moving & Storage Services, Inc. He was responsible for overseeing the company's quarterly deposits for employee withholding taxes. Taxpayer filed for bankruptcy under Chapter 7 of the Bankruptcy Code and a discharge order was issued on January 4, 2000.

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On December 8, 1999, the IRS sent the taxpayer by certified mail a Letter 1153, Trust Funds Recovery Penalty ("TFRP") Letter proposing to assess $45,959 pursuant to Section 6672. Taxpayer did not appeal. On March 20, 2000, the TFRP were assessed against the taxpayer as a responsible party.

On February 5, 2008, the IRS recorded a notice of Federal tax lien in the amount of $40,851 and sent the taxpayer a notice of the tax lien filing and his right to a hearing. In response, the taxpayer submitted a Form 12153. The only issue the taxpayer raised in his Collection Due Process ("CDP") hearing was his underlying liability for the TFRP. On July 23, 2008, a CDP hearing was held via telephone. Taxpayer argued that the taxes were paid by Barry Moving.

At trial, the taxpayer testified that he never received the Letter 1153 and the Court found his testimony to be credible. At trial, the taxpayer did **not** argue that he was not liable for the TFRP. Instead, he argued that Barry Moving paid the taxes due. However, the taxpayer was unable to produce any bank records or any other documentation showing that Barry Moving paid the taxes.

Law: A taxpayer's liability for trust fund taxes is not a dischargeable debt in bankruptcy. See 11 U.S.C. section 523; Washington v. Com'r, 120 T.C. 114, 121 (2003); U.S. v. Sotelo, 436 U.S. 268, 282 (1978).

Holding: Because taxpayer failed to demonstrate that he paid the taxes and did not contest his trust fund liability under Section 6672, and because his liability for the TFRP was not discharged by the Bankruptcy Court, the IRS could proceed with collection by lien.

Temporary Regulations – What are their Effect?

Intermountain Insurance Service of Vail, LLC v. Com'r, 134 T.C. No. 11 (5-6-2010)

Background: On September 1, 2009, the Court issued a prior opinion in this case. The Court ruled that the adjustments the IRS made in its final partnership administrative adjustment (FPAA) are barred by the general 3 year statute of limitations. See T.C. Memo 2009-195. The IRS had argued that a 6 year period of limitations applied because the taxpayer overstated its basis. The issue was whether an overstatement of basis is an omission from gross income for purposes of triggering the 6 year limitations period. The Tax Court noted that in Bakersfield Energy Partners, L.P. v. Com'r, 128 T.C. 207 (2007); aff'd 568 F.3d 767 (9th Cir. 2009). the Tax Court held a basis overstatement was not an omission. The Court applied the holding of Colony Inc. v. Com'r, 357 U.S. 28, 33 (1958) which construed Section 6501's predecessor.

On September 24, 2009, the Treasury Dept. issued temporary regulations that provided an understated amount of gross income resulting from an overstatement of unrecovered

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cost or other basis constitutes an omission from gross income for purposes of Sections 6229(c)(2) and 6501(e)(1)(A).. Based on the application of the temporary regulations to this case, the IRS filed motions to vacate the Court's decision and to reconsider its opinion.

Issue: Whether the temporary regulations compel the Tax Court to grant the IRS's motions?

Law: The decision to grant motions to reconsider and to vacate lies within the discretion of the Court. Estate of Quick v. Com'r, 110 T.C. 440, 441 (1998); Kun v. Com'r, T.C. Memo 2004-273). The moving party bears the burden of proving entitlement to relief. Kraasch v. Com'r, 70 T.C. 623, 626 (1978). Motions to vacate are generally not granted absent a showing of unusual circumstances or substantial error, e.g., mistake, inadvertence, surprise, excusable neglect, newly discovered evidence, fraud, or other reason justifying relief. Fed. Rule of Civil Pro. 60(b); Brannon's of Shawnee, Inc. v. Com'r, 69 T.C. 999 (1978). An intervening change in the law can warrant the granting of both a motion to reconsider and a motion to vacate. Alioto v. Com'r, T.C. Memo 2008-185.

Analysis: to answer the issue, the Court first addressed whether the temporary regulations apply by their own terms. The temporary regulations provide that the rules of this section apply to taxable years with respect to which the applicable period for assessing tax did not expire before September 24, 2009. However, the Court noted that in its prior opinion it concluded the applicable period for assessing tax in this case expired some time before September 14, 2006. Accordingly, the plain meaning of the applicability date provisions of the temporary regulations indicate they do not apply in this case.

Ordinarily, an agency's interpretation of its own regulation is controlling unless it is plainly erroneous or inconsistent with the regulation. Auer v. Robbins, 519 U.S. 452, 461 (1997). In this case, however, the Tax Court found the IRS's interpretation to be erroneous and inconsistent with the regulations.

However, the Court stated that: "The question is whether we are bound by the agency's construction of the statute in the temporary regulations or by the Supreme Court's prior determination of congressional intent and the Internal Revenue Code's requirements, as set forth in Colony, Inc."

In Natl Cable & Telecomms, Association v. Brand X Internet Servs., 545 U.S. 967, 982 (2005) the Supreme Court wrote: "A court's prior judicial construction of a statute trumps an agency's construction otherwise entitled to Chevron deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion." In determining whether the Supreme Court in Colony Inc. found the statutory provision at issue to be ambiguous, the Tax Court considered the court's analysis of both the statutory language and its legislative

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history. After thoroughly reviewing the legislative history, the Supreme Court concluded that Congress' intent was clear and that the statutory provision was unambiguous.

Decision: The IRS's motions are denied because the temporary regulations are invalid and are not entitled to deferential treatment.

Valuation of TIC Interests Transferred to a Qualified Personal Residence Trust

Ludwick v. Com'r, T.C. Memo 2010-104 (5-10-2010)

Facts: Andrew and Worth Ludwick owned a vacation home as tenants-in-common, each spouse owning an undivided one-half interest. In 2000, they had bought unimproved real estate in Hawaii. In 2003, they had a vacation home built on it. In December, 2004, each spouse established a separate qualified personal residence trust. In February, 2005, each transferred their undivided interest to their trust. At the time of the transfers, the property had a fair market value of $7.25 million and an annual operating cost of about $350,000.

Each spouse filed a separate Federal gift tax return. They valued their gift of their separate 50% interest using a discount of 30%. The reported gift was $2,537,500 ($7.25 million x 50% = $3,625,000 x 70% = $2,537,500).

The IRS used a discount of 15% so the gift was $3,081,250. In Court, the IRS argued for a 11% discount and a gift of $3,226,250.

Issue: What is the value of the gift?

Holding: The Court found the FMV of each undivided one-half interest to be $3,000,089 using a discount of about 17%.

Analysis: The Court did not find the analysis of either side's expert convincing. The Court criticized the analysis of each expert noting:

"He provided no way for us to evaluate his analysis however. He failed not only to explain how the discounts were calculated (i.e. how did he calculate the underlying fair market value?) but also to provide any measure of the variability or dispersion of his data points (e.g., their standard deviations). Most importantly, he did not provide any of the data; we do not know the specifics of any of the undivided interest transactions. We have no way to know how comparable those properties were to the ones here in issue."

The Court asked each expert why a buyer of an undivided interest in the property would consider the interest worth any less than a proportional share of the fair market value of the whole property reduced by the cost to the buyer of partition. Both experts convinced the Court that a buyer would also take into account marketability or liquidity risk but they

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disagreed as to the size of the appropriate discount and whether partition would even be necessary.

Hawaii law provides for partition of real property. A buyer would be willing to pay an amount equal to the present value of (1) the FMV of a 50% interest less (2) his costs of maintaining the property and his costs of selling the property and perhaps the cost of partition.

To determine such price, the Court focused on: (1) the length of the partition process, its costs, and the likelihood partition would be necessary; (2) the rate of return the buyer would demand; and (3) the value of 50% of the property upon sale. Estate of Barge v. Com'r, T.C. Memo 1997-188.

Regarding the first factor, the Court found that a contested partition would take two years to resolve including one year to sell the property and that the costs necessary by the litigation would be 1% of the value of the property or $72,500 or $36,250 for a 50% interest.

The Court also found that a buyer would expect partition to be necessary 10% of the time and the cost of selling the property would be 6% of the FMV or $435,000 or $217,000 for each half.

Regarding the second factor, the IRS's expert testified a buyer would demand a 10% return. The taxpayers' expert testified that a buyer would demand a 30% return but "presented no evidence to support that conclusion." Since the taxpayers failed to prove that a buyer would demand a return a return greater than 10%, the Court used 10%.

Regarding the third factor, the parties stipulated the property's FMV was $7,25 million. The taxpayers' expert testified that the long-term sustainable growth rate of real estate was 3% annually. Accordingly, at the end of year 1 (if partition was not necessary) or 2 years (if partition was necessary) the property would sell for $7,467,000 or $7,691,525, respectively or $3,733,750 and $3,845,763, respectively for a 50% interest.

The Court then took the expected sales price for a 50% interest and subtracted the operating costs and sales costs to determine the expected new sale proceeds at the end of 1 year and 2 years. It also considered two possibilities: the property would be sold after one year without partition and that it would be sold at the end of two years with partition but with a 10% chance of partition. It then used the weighted average of the two present values that it calculated and calculated the weighted average FMV of $3,000,009.

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Dennis J. Gerschick, JD, CPA, CFA

Dennis Gerschick has a unique background. He is the only individual who is an Attorney, CPA, Chartered Financial Analyst, and Venture Capitalist and has work experience in each field.

Mr. Gerschick graduated Florida Atlantic University in 1978 (major in accounting). He passed the May, 1978 CPA exam on his first attempt. He then worked as a CPA with Ernst & Young, one of the Big 4 accounting firms, before graduating from Drake Law School in 1983.

After law school, Mr. Gerschick worked in the tax department of one of Atlanta's largest law firms, Powell, Goldstein. Later, Mr. Gerschick opened his own law firm. His practice focused on representing closely-held businesses and their owners. For many clients, he also acts as a business and financial advisor.

Mr. Gerschick is the President of VenCap Advisory Group, Inc. which is the sole general partner of VenCap Opportunities Fund, L.P., a venture capital fund. Mr. Gerschick's duties include finding companies in which to invest, reviewing and evaluating hundreds of business plans, as well as negotiating, structuring, documenting, and monitoring the fund's investments. He has also served on several boards of directors and audit committees.

Mr. Gerschick served on the American Institute of CPA's Business Valuation Subcommittee.

Mr. Gerschick also provides a variety of legal and consulting services. He provides tax, investment, financial and business advice to a variety of companies and investors. He consults with other CPAs and attorneys to help them better serve their clients, or he provides a second opinion. See www.Gerschick.com

Mr. Gerschick speaks frequently at seminars and conferences throughout the country regarding a variety of investment, legal, and tax topics. He has spoken about the purchase or sale of a business, real estate, corporate governance, financing businesses, financial statement analysis, and many other topics. See www.RegalSeminars.com

Mr. Gerschick has written many articles, relating to growing and financing businesses that have been published by the Technology Law Section of the Georgia Bar and the Michigan Association of CPAs. Mr. Gerschick has authored two monographs, Raising Capital and Attracting Investors to Your Start-Up, both of which are offered by the Capital Formation Finance Institute in Washington DC. See www.cfi-institute.org. An interview with Mr. Gerschick was also published in American Venture, a magazine targeted at entrepreneurs and accredited investors.

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